

DOCKET SECTION

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POSTAL RATE COMMISSION

Docket No. R97-1

POSTAL RATE AND FEE CHANGES, 1997

TRIAL BRIEF OF
THE DIRECT MARKETING ASSOCIATION, INC.

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WASHINGTON, D.C. 20268-0001**

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Pursuant to Presiding Officer's Ruling No. R97-1/55 (Nov. 5, 1997) and the Chairman's comments at the July 30, 1997 hearing in this proceeding, the Direct Marketing Association, Inc. ("The DMA") is submitting this "trial brief" to set forth its views, and provide the rationale underlying those views, with respect to two significant issues raised in this case: (1) the appropriate method for attributing mail processing costs and (2) the appropriate allocation, based on application of the statutory pricing factors on this record, of institutional costs among the classes of mail.

**I. THE COMMISSION SHOULD REJECT WITNESS DEGEN'S
PROPOSED MAIL PROCESSING COST DISTRIBUTION
METHODOLOGY AND MAINTAIN THE IOCS/LIOCATT SYSTEM
APPROVED IN R94-1**

The mail processing component of Cost Segment 3 is the largest single component in the Postal Service cost system, comprising more than \$13 billion in costs or almost 25 percent of the total accrued costs in Base Year 1996. DMA-T-1 at

2. In the Postal Rate Commission's Opinion and Recommended Decision in Docket No. R94-1 ("Op. R94-1"), the Commission requested that the Postal Service address

four areas of concern relating to the use of IOCS data and the LIOCATT distribution system to distribute mail processing costs to subclasses. These issues were: (1) the lack of resources devoted to IOCS; (2) the increase in the number and proportion of mixed mail tallies; (3) the lack of analysis about the effect on IOCS of a shift to an automated environment; and (4) questions about the increase in break time and not handling mail time. Op. R94-1 at ¶ 3023 (p. III-8).

Unfortunately, during the intervening three years, the Postal Service did not effectively address these concerns. Notwithstanding its assertions to the contrary, the Postal Service collected virtually no empirical data and performed no quantitative studies on the contents of mixed mail, the causes of not handling costs, or the increases in both mixed and not handling costs. Rather, the Postal Service's "improvements" consist of witness Degen's proposals to distribute such costs to subclasses in R97-1 using untested assumptions, which produce thin distribution keys, and incongruous data tainted by employee misclocking. As a result, witness Degen's cost distributions are extremely speculative. The Commission should reject this approach.

A. **Witness Degen's Approach Applies Untested Assumptions Concerning the Subclass Composition of Mixed Mail and Distributes Mixed Mail Costs Within Cost Pools Using Extremely Thin Distribution Keys**

In his direct testimony, DMA witness Buc summarizes the current IOCS/LIOCATT system used to distribute mail processing labor costs to subclasses and special services, as well as Mr. Degen's proposed cost distribution methods.

DMA-T-1 at 7-15. Mr. Degen claims that his method improves on prior mail processing cost distribution methods. USPS-T-12 at 5-11. This claim is simply without merit.

Mr. Degen's approach is not based on any data regarding the subclass composition of mixed mail beyond that available in R94-1 and prior rate cases. In fact, in several respects, Mr. Degen's cost distribution proposal is inferior to that currently used in the IOCS/LIOCATT system. The only hard data the Postal Service has for mail processing cost attribution continues to be information derived from direct IOCS tallies. Mr. Degen's proposed cost distribution applies several untested and probably erroneous assumptions regarding the subclass composition of mixed mail, namely that the contents of direct mail represent the contents of mixed mail within the same item type and cost pool. See DMA-T-1 at 12-14. The problems associated with these assumptions are compounded by the creation of 50 mail processing cost pools which produce distributing sets with very few tallies.

1. Witness Degen Applies Untested Assumptions Concerning the Subclass Composition of Mixed Mail

Mr. Degen first assumed that the subclass composition of uncounted and empty mixed items by item type and cost pool is the same as the subclass composition of direct items of the same item type and cost pool.^{1/} Based on this

^{1/} In this context, the subclass composition of "empty" items refers to the subclasses of mail that were contained in the empty items before they were emptied; however, Mr. Degen has no data on which to calculate this empty item subclass composition. See MPA-T-2 at 27-28.

assumption, he distributed mixed item costs to subclasses in proportion to direct tally costs of the same item type and cost pool. Mr. Degen then assumed that the subclass composition of items and loose shapes in identified mixed containers is the same as the subclass composition of items and shapes outside of such containers by item or shape type and cost pool; he then distributed such costs to subclass or special service in the same manner as he did for mixed items.^{2/} Finally, witness Degen assumed that the subclass composition of unidentified and empty mixed containers is the same as the contents of identical and identified containers of the same container type in the same cost pool and distributed such costs accordingly. See DMA-T-1 at 12-14.

Mr. Degen conceded that he made these assumptions concerning the subclass composition of mixed mail. Tr. 12/6658-63. Moreover, he admitted that he did not perform any studies to determine whether any of the mixed mail costs thus distributed were causally related to particular subclasses. Tr. 12/6665-66. Witness Degen also admitted that he was unaware of any quantitative studies performed by the Postal Service to determine whether the subclass composition of uncounted items was similar to that of counted items, whether the subclass composition of unidentified containers was similar to that of identical and identified containers, or whether the subclass composition of items in containers was similar to that of items not in containers. Tr. 12/6218, 12/6665.

^{2/} Moreover, this data lacked precision: in the new system, data collectors merely "eyeballed" the percentage of volume of an identified mixed container consisting of various items or loose shapes. Tr. 12/6297-6299.

In fact, Mr. Degen's proposal in R97-1 to distribute uncounted item costs solely based on direct item costs is similar to a proposal that was opposed by the Postal Service and rejected by the Commission in the R94-1 proceeding. Op. R94-1 at ¶¶ 3059-3073 (pp. III-20 to -23). MPA witness Cohen and TW witness Stralberg testified that the empirical evidence that does exist seems to show the opposite of Mr. Degen's approach because: (1) neither identical items (primarily Standard A and Periodicals) nor counted mixed items have the same characteristics as uncounted mixed items; and (2) the subclass composition of items and loose shapes in containers is likely to be different from the contents of items and loose mail outside of containers. MPA-T-2 at 23-26; TW-T-1 at 16-17. In sum, Mr. Degen has provided no empirical support for his assumptions concerning the subclass composition of mixed mail.

2. Witness Degen Distributes Mixed Mail Costs Within Cost Pools Using Extremely Thin Data

Mr. Degen's approach also results in a significant increase in the number of distributing sets as compared to those used in prior rate cases. Many of these distributing sets contain few direct tallies, resulting in distribution keys fraught with sampling error which are unsuitable for ratemaking purposes. See DMA-T-1 at 20-24.

For uncounted or empty mixed items, witness Degen used 467 distributing sets within the appropriate cost pools; nearly 30 percent of these distributing sets (representing ten percent of the distributed costs) for

uncounted/empty items are based on five or fewer direct tallies. For identified mixed containers, Mr. Degen used 578 distributing sets; more than 25 percent of these distributing sets contain five or fewer tallies, and about ten percent of the costs for these containers are distributed on 25 or fewer tallies. Finally, for unidentified and empty mixed containers, witness Degen used an additional 360 distribution keys; almost 30 percent of these distributing sets containing five or fewer tallies, and more than 25 percent of the costs for these containers are distributed on the basis of 30 or fewer tallies. See DMA-T-1 at 12-14, 20-23.^{3/}

Such thin data results in 70 percent of the sets of subclass costs which form the basis of witness Degen's distribution keys having coefficients of variation ("CV," a measure of sampling error) greater than 50 percent. As witness Buc testified, a "CV this large indicates that the underlying cost data are too uncertain to be used as a basis of distributing costs to subclasses." DMA-T-1 at 24.

B. Witness Degen Assumes Without Support that Not Handling Mail Costs Are Caused by the Subclasses of Mail Responsible for Direct Costs Within Cost Pool

\$5.4 billion of mail processing costs are for "not handling costs."^{4/}

DMA-T-1 at 25. Overhead costs have grown dramatically from 20.8 percent in FY86

^{3/} The number of distributing sets actually used is determined by the number of sets of data that need to be distributed by cost pool and item type. Mr. Degen's method has the potential of using 784 distribution sets for mixed items, 1029 sets for identified mixed containers and 490 for unidentified and empty containers. DMA-T-1 at 13-14, 20; MPA-T-2 at 28-29.

^{4/} These costs primarily consist of clocking in and out of operations, breaks and personal needs, and handling empty equipment other than items and containers.

to 31.5 percent in FY96 of direct and mixed mail costs. TW-T-1 at 27. In Mr. Degen's methodology, not handling costs amount to 83 percent of the combined direct and distributed mixed mail tally costs for all MODS cost pools; not handling costs constitute over half of the total costs in 18 of the 39 MODS cost pools. DMA-T-1 at 25-26. However, the Postal Service ignored the Commission's request that it study the causes and growth of these costs and compounded the problem by attributing these costs without any empirical support to subclasses within cost pools.

Witness Degen's methodology assumes that the activities and related costs for employees who are not handling mail and are clocked into a specific operation are caused by the mail processing activities performed by employees clocked into that operation. Thus, he generally distributed such costs in proportion to the direct and distributed mixed mail costs within each cost pool. DMA-T-1 at 14-15, 25; USPS-T-12 at 10; Tr. 12/6664. However, Mr. Degen admitted that he performed no studies to determine whether any of the not handling mail costs were causally related to particular subclasses of mail. Tr. 12/6666.^{5/}

Several witnesses (Mr. Buc, Ms. Cohen, and Mr. Stralberg) testified that some of these not handling costs are due to excess labor comprised of automation refugees no longer needed in automated or mechanized operations who have been reassigned to manual allied operations where productivity is not measured

^{5/} Moreover, Mr. Degen ignored IOCS tally information which directly associates certain not handling costs to a specific subclass or special service (e.g., special delivery, registry and Express Mail). See TW-T-1 at 33-34.

(e.g., opening units or platform activities). See, e.g., DMA-T-1 at 26 and n. 29; TW-T-1 at 27-30; MPA-T-2 at 13, 27. In fact, the percentage of not handling costs is very high (50-60 percent) in certain manual operations (such as platforms and opening units) which should have lower not handling costs than automated operations. MPA-T-2 at 12-13, 26-27.^{6/} Highly presorted mail (such as Standard A and Periodicals) spends a high proportion of time in allied operations, such as platforms and opening units. TW-T-1 at 32. Thus, assigning not handling costs within cost pools is not only unsupported, but also unfairly burdens presorted mail. TW-T-1 at 32; MPA-T-2 at 27.

C. **Misclocking by Postal Service Employees Contributes to Inappropriate Distribution Keys**

Mr. Degen's distribution method is further impaired because it distributes costs based on the IOCS direct tallies within cost pools derived from the MODS operation into which the employee is clocked; the "clocked in" MODS activity may differ from the operation that the employee is actually performing. See USPS-T-12 at 6-7; Tr. 17/8134, 17/8138-39; DMA-T-1 at 8, 19 and n.25; MPA-T-2 at 28. Such "misclocking" has resulted in inappropriate tallies showing, for example, flats and parcels processed in letter operations and parcels processed in flats operations. DMA-T-1 at 19-20. Misclocking can result in inaccurate distribution keys because the mixed mail and not handling costs in the cost pool into which the

^{6/} Not handling costs are also large in letter and flat sorting machines, which indicates decreased productivity at these operations. MPA-T-2 at 13-14.

employee is clocked will be distributed, in part, on activities performed in the cost pool in which the employee is actually working. DMA-T-1 at 19-20; MPA-T-2 at 28.^{2/}

D. No Other Witnesses Provide Credible Support for Witness Degen's Proposed Cost Distribution Methods

No other witness has provided credible support for Mr. Degen's approach. UPS witness Sellick summarily argues that Degen's approach is an improvement over the prior use of the IOCS/LIOCATT system. See UPS-T-2 at 4-11. However, Mr. Sellick provides no statistical analysis or empirical support concerning the subclass composition of mixed mail or the causation of not handling costs and has not addressed the problems of extremely thin distributing sets or employee misclocking. See DMA/UPS-T2-1(b), 4(a), 5.

The DMA witness Buc demonstrated that Mr. Degen's methodology should not be adopted, because (1) it relies on several untested and erroneous assumptions concerning the subclass composition of mixed mail, (2) not handling costs should not be distributed based on direct and mixed mail tallies within cost pool, and (3) the use of more than 1000 distribution keys for mixed mail results in

^{2/} Misclocking also contributes to the need to reweight IOCS tallies because the sum of all weighted IOCS tally costs within a cost pool (derived from the sampled activity) does not equal the accrued cost for the cost pool (derived from the MODS operation into which the employee is clocked). This reweighting is often substantial: in almost half of the MODS cost pools, IOCS tallies must be reweighed by at least 10 percent. DMA-T-1 at 18. Mr. Degen conceded that misclocking could contribute to the need to reweight tallies. Tr. 17/8138.

unreliable distributions. DMA-T-1 at 12-26. MPA witness Cohen and TW witness Stralberg essentially agree with Mr. Buc. See MPA-T-2 at 15-29; TW-T-1 at 9-37.

E. The Commission Should Maintain the IOCS/LIOCATT System for Distributing Mail Processing Costs

Witness Buc recommends that the Commission should reject Mr. Degen's method and maintain the IOCS/LIOCATT method whereby mixed mail and not handling mail costs are based on direct tally costs and distributed by CAG, function, and shape (if appropriate) and not within MODS cost pool. DMA-T-1 at 27. Although this method certainly could and should be improved, it is the best available on this record and is superior to Mr. Degen's approach. Returning to the IOCS/LIOCATT system will also redistribute window service and administrative/support costs not related to mail processing back to their traditional component.^{8/}

The IOCS/LIOCATT method avoids Mr. Degen's untested assumptions concerning the subclass composition of mixed mail and the causation of not handling costs, as well as the data thinness issue (because distributing sets consist of many more tallies) and misclocking problems (because the MODS operation into which the employee is clocked is irrelevant in the IOCS/LIOCATT system).

^{8/} As a much worse alternative, if the Commission accepts any part of Mr. Degen's proposals, it should modify its most egregious problems. Witness Buc provides an alternative version of Degen's approach by: (1) distributing volume-variable IOCS weighted tally costs (rather than volume-variable MODS pool costs); (2) distributing mixed mail costs across cost pools and item or container types rather than within them; and (3) distributing not handling costs across cost pools rather than within pools. DMA-T-1 at 27-28.

Ultimately, the Postal Service must collect more data on the subclass composition of mixed mail and effectively address the growth in, and the causes of, not handling costs. The DMA respectfully urges the Commission to repeat, in unmistakable terms, its request that the Postal Service conduct the studies necessary to permit a truly improved method for attributing mail processing costs.

II. UNDER A PROPER APPLICATION OF THE STATUTORY PRICING PRINCIPLES, STANDARD (A) MAIL SHOULD BEAR A PORTION OF INSTITUTIONAL COSTS SMALLER THAN THAT PROPOSED BY THE POSTAL SERVICE

The most important pricing issue confronted by the Commission in this case involves the proper allocation of the Postal Service's substantial institutional costs among the various classes of mail, especially as between First-Class Mail and Standard (A) Mail. In the past several cases, the Commission has developed an "iterative ratemaking process" by which the Commission exercises its judgment to apply the pricing factors set forth in Section 3622(a) to allocate institutional costs among the various classes of mail. Op. R90-1 at ¶¶ 4005-08 (pp. IV-2 to -3), Op. R87-1 at ¶ 4063 (p. 379). In this case, Postal Service witness Donald J. O'Hara (USPS-T-30) has applied such a process to support the allocation of institutional costs reflected in the Service's proposed rates.

The single most important element in establishing fair and equitable allocations of institutional costs is the relationship between the contribution made by First Class mail and that made by Standard (A) (previously Third Class) mail. The

Commission has recognized in prior cases that these two classes account for the vast majority of postal revenues (78.8 percent of TYAR revenues in this case, see Exh. USPS-30B), and that the allocation of institutional costs to these classes therefore largely determines the relative allocation of such costs to the other classes of mail. See, e.g., Op. R94-1 at ¶ 4048 (p. IV-18).

In this proceeding, the Postal Service has proposed the following TYAR cost coverages, coverage indices and markup indices for these classes of mail (Exh. USPS-30B):

| <u>USPS Proposed Allocation of Institutional Costs</u> (Exh. USPS-30B, Revised 9/19/97) | | | | |
|--|----------|----------------|---------|---------------|
| | Coverage | Coverage Index | Mark-Up | Mark-Up Index |
| First Class | | | | |
| Letters | 200% | 1.12 | 100% | 1.28 |
| Total | 199.5% | 1.12 | 99.5% | 1.27 |
| Standard (A) | | | | |
| Commercial | 174% | 0.98 | 74.2% | 0.95 |
| Total | 167% | 0.94 | 67.0% | 0.85 |

A. Proper Application of the Statutory Pricing Factors Requires a Reduction in the Relative Institutional Cost Burden Borne by Standard (A) Mail

The DMA does not quarrel with the need for the Commission to exercise its judgment in the application of the statutory pricing factors, or with the iterative process adopted by the Commission and followed by Mr. O'Hara here. In

The DMA's view, however, neither Mr. O'Hara's testimony nor any other evidence in this record -- nor any Commission precedent -- supports the allocation of institutional cost burdens reflected in the Postal Service's proposed rates for First Class and Standard (A). Proper application of the statutory pricing factors on this record requires that the Commission recommend rates for Standard (A) that reflect a reduced share of institutional costs relative to that proposed by the Postal Service.

Application of the pricing factors set forth in Section 3622(a) to the evidence of record in this case compels the conclusion that the proposed contribution to institutional costs made by Standard (A), as compared to that of First Class, is too great. All of the pertinent pricing factors support a contribution factor (or markup) for Standard (A) that is significantly below that for First Class, whereas the Postal Service's proposed coverages (and markups) do not reflect a sufficient difference. In fact, the Postal Service's own pricing witness, Mr. O'Hara, confirms that all of the statutory pricing factors are either neutral as between First Class and Standard (A) mail, or call for Standard (A) mail to bear a significantly lower institutional cost burden than First Class. See DMA/USPS-T30-1(a) & (b).

As Mr. O'Hara's testimony explains, relative to First Class letters, Standard (A) mail is characterized by a significantly lower intrinsic value of service and a significantly higher elasticity of demand (Criteria 2) (e.g., USPS-T-30 at 22-23, 32-33, DMA/USPS-T30-3), indicating a significantly lower contribution/markup for Standard (A), and no other factor supports a lower contribution (or markup) for First

Class. In this case, the other criteria are essentially neutral as between First Class and Standard (A). For example, at the modest level of the rate increases proposed by the Postal Service in this case (reflecting the relatively small increase in the revenue requirement), there is no need for the Commission to moderate the proposed increase in First Class rates to take account of an adverse impact on mailers under Criterion 4. See USPS-T-30 at 23, 33. Similarly, the availability of alternatives (Criterion 5) does not strongly favor one of these classes over the other. The majority of the mail in both classes is subject to the Postal Service's statutory monopoly, see, e.g., Op. R90-1 at ¶ 4022 (p. IV-8), and in recent years there has been a widely-acknowledged explosion in the availability of alternative means of communicating written material, including E-Mail via the Internet, electronic bill payment and facsimile transmissions. See USPS-T-30 at 23; see also pp. 17-18, infra. This trend has significantly reduced the extent to which First Class mailers are captive to the services provided by the Postal Service. Accordingly, The DMA submits that proper consideration of the statutory pricing factors demands that there be a significant spread between the relative contributions toward institutional costs of First Class and Standard (A) mail.

Mr. O'Hara's proposed allocation does not reflect an adequate spread.^{9/}

To achieve the fair and equitable rate and markup relationships demanded by the

^{9/} Indeed, Mr. O'Hara's proposed coverages would result in mark-up indices for Standard (A) Commercial and First Class Letters that are closer together than those recommended by the Commission in R94-1 and R87-1. Compare Exh. USPS-30B with R94-1, App. G., Sched. 3 at 2.

evidence in this record, the contribution of Standard (A) must be reduced relative to that for First Class in comparison to the levels proposed by Mr. O'Hara.

The Commission has often stated that it believes that the coverage factors for First Class and Standard (A) (then Third Class) mail should be relatively close to one another and near the systemwide average in order to maintain the "historic balance" between these classes. E.g., Op. R94-1 at ¶ 4049 (p. IV-18); Op. R90-1 at ¶¶ 4021-22 (pp. IV-7 to -8) ("basic tenets" that "First-Class should bear a markup at, or slightly above, systemwide average" and that "third-class bulk regular . . . should also bear an approximately average markup"), ¶ 4055 (p. IV-18), ¶¶ 4057-59 (pp. IV-19), ¶¶ 4102-03 (pp. IV-31 to -32), ¶ 4110 (p. IV-35); Op. R87-1 at ¶ 4026 (p. 367) (describing "general goal in each case . . . that First-Class cost coverage should be close to systemwide average"), ¶ 4148 (p. 403). This "tenet," however, has no proper bearing on the application of the statutory pricing factors to First Class and Standard (A) mail in this case.

First, one searches in vain in the past Commission opinions for any justification of the Commission's "previous conclusion" that the cost coverages for both Standard (A) and First Class should be "close to system-wide coverage." Each opinion simply refers to "history" and asserts the principle in conclusory terms as if it were a firmly established statutory command. The only statement the Commission has ever made to justify this relationship under the statutory pricing factors was its comment in R90-1 about the need to take "care" to "avoid unfairly penalizing First-

Class Mail, which is the basic means of written personal and business communication in this country, yet is subject to a statutory monopoly." Op. R90-1 at ¶ 4021 (pp. IV-7 to -8); see also Op. R87-1 at ¶ 4144 (p. 402). Cf. Op. R84-1 at ¶ 5020 (pp. 323-24) (Postal Service monopoly over letter mail given "primary consideration in our determination to recommend First-Class rates which are as low as conditions will allow"). As the Commission noted in the same breath, however, that monopoly applies to Third Class (and now Standard (A)) mail as well. Op. R90-1 at ¶ 4022 (p. IV-8). Moreover, as explained below, the Postal Service's monopoly grip over First Class mailers is eroding swiftly with the advent of alternative electronic means of effecting written business and personal communications (including now even color pictures and animation). The supposed "tenet" that First Class and Standard (A) markups should be near each other and thus near systemwide average is at most a historical remnant that has never been justified by any principled application of the Act's pricing factors.

Indeed, even the supposed "historical" foundation for this tenet does not bear up under scrutiny. Beginning with R87-1, the distinct trend has been for the Commission to recommend markup indices for First Class and Third Class that are closer and closer to average, and indeed certain factors in that case (i.e., very high percentage increases in Third Class mail rates) prevented the Commission from recommending Third Class markups as close to First Class markups as it would have liked. See Op. R87-1 at ¶¶ 4139-50 (pp. 400-04). Were "historical relationships" --

rather than the Commission's own, more recent judgments -- the true foundation for these pricing decisions, they would support markups that are farther apart, not closer together. See Op. R94-1, App. G. Sched. 3 at 2.

Second, even if the Commission's conclusions about the desirable relationship between the markups for First Class and Third Class were ever justified, those past conclusions cannot properly be relied upon in this case. The Commission has frequently emphasized that its pricing judgments are appropriately based on judgments reached in prior cases only where there have been no material changes in circumstances. See, e.g., Op. R90-1 at ¶ 4058 (p. IV-19) (noting that no compelling reason was provided for altering the "historic balance between First- and Third-Class"). Here, however, there have been several fundamental changes in circumstances.

Most pertinent to the application of the statutory pricing factors, the record in this case contains irrefutable evidence that there has been a significant expansion in the availability of alternatives for First Class and other mailers. In recent years, the use of electronic media to communicate written material -- including color pictures, animation, sound recordings and other sophisticated content -- that previously could have been sent only via letters has increased exponentially. Perhaps more importantly, those alternatives have become dramatically more accessible to ordinary citizens as a result of the constantly-improving accessibility of the Internet. See, e.g., USPS-T-30 at 23. E-Mail (via the Internet and other proprietary services),

electronic bill payment and facsimile transmissions via telephone provide readily, and increasingly, available means for First Class mailers to escape the Postal monopoly. The basis for the Commission's apparent presumption that First Class mailers require special protection is gone or at least eroding rapidly.

Equally important are the changes in the classification and operational framework in which rate and markup relationships are to be established in this case. This is the first omnibus rate case since reclassification, and the Postal Service has made significant progress implementing its automation initiative. Those developments have made available to many First Class (and Standard (A)) mailers opportunities to participate in worksharing and thereby realize significant discounts off standard rates. In addition, the Postal Service has proposed in this case sweeping changes in the methodologies by which its costs are to be attributed to the various classes of mail and, for the first time, has introduced evidence bearing on incremental costs that will permit the Commission to perform objective tests to ensure against cross-subsidization. See USPS-T-5; USPS-T-11; USPS-T-41. Taken together, these changes have resulted in a fundamental shift in the foundation upon which the Commission must apply its pricing judgment to arrive at rate and markup relationships that are fair and equitable under the standards established in Section 3622(a). In this case more than any that has come before, reliance on history and tradition will not suffice to justify the relative institutional cost burdens reflected in the rates recommended by the Commission.

B. The Rate Relationships Dictated by Application of the Statutory Pricing Factors Should Not Be Trumped by the Interplay of the Revenue Requirement and the Whole-Cent Requirement for First Class First-Ounce Rates

The Commission has properly recognized the difficulty of achieving proper rate and markup relationships given that the single largest source of USPS revenues -- the First Class first-ounce rate -- must be increased (or decreased) in whole-cent increments, and thus cannot be adjusted to achieve desired rate relationship without quite large impacts on revenues. See Op. R87-1 at ¶¶ 4126-4127 (pp. 397-98); see also Op. R94-1 at ¶ 4048 (p. IV-18). Given this relative inflexibility in the First Class rate structure, The DMA recognizes the possibility that, in light of the Postal Service's unexpectedly profitable performance in recent months, adjustments in First Class and Standard (A) rates to bring their relative coverages into proper relationship to one another may result in the Postal Service's total TYAR revenues being somewhat in excess of its revenue requirement.

In The DMA's view, it would be inappropriate for the Commission to address this "problem" by adjusting rates in a way that alters the rate relationships judged to be fair and equitable based on the application of the Commission's pricing judgments (as would be the case, for example, were the Commission to recommend no increase in the First Class stamp). The Commission has ample alternative means of avoiding the dilemma of excess revenues without doing violence to proper rate relationships. For example, the Commission could make adjustments with respect to prior-year loss recovery.

In addition, and perhaps most appropriate for the situation presented here, the Commission should urge that the Postal Service postpone the effective date of any rate increases recommended by the Commission for a period of time sufficient to eliminate the excess revenues. The Postal Service manifestly has discretion to delay implementing rate increases recommended by the Commission, see Newsweek, Inc. v. USPS, 663 F.2d 1186, 1204 (2d Cir. 1981), aff'd sub nom. Nat. Ass'n of Greeting Card Pub. v. U.S. Postal Service, 462 U.S. 810 (1983), and it would be appropriate for the Commission to assume that the Postal Service will exercise its discretion in the public interest so as to avoid earning excess revenues. Such a course is far preferable to jettisoning rates that are otherwise "fair and equitable."

C. Witness Chown's Proposed "Weighted Attributable Cost" Metric Should Be Rejected

One other specific pricing-related proposal warrants comment at this time. NAA witness Sharon L. Chown (NAA-T-1) has proposed that the Commission establish a "metric," which she calls "total weighted attributable costs," that the Commission would use in "guag[ing] the appropriate level of the institutional costs to be borne by each subclass of mail." NAA-T-1 at 2. Ms. Chown seeks to justify her proposal by objecting to the Commission's traditional approach of applying a markup or cost coverage to a "single pool of total attributable costs for each subclass," on the ground that it "ignores the relative mix of the different postal functions used by each subclass and the contribution of each of these functions to the total institutional costs of the Postal Service." Id. at 4. Ms. Chown says that her "metric" provides a way of

accounting for these differences. Ms. Chown proposes that the Commission apply markups not to actual attributable costs, but instead to a "metric" that supposedly reflects attributable costs that have been "weighted" according to the subclasses' mix of functions and the proportion of total institutional costs "incurred to provide" those functions. Id. at 13-14.

Ms. Chown's proposal should be rejected. The Commission has already rejected a substantively identical approach proposed by Ms. Chown in R90-1 because the Commission already has a better way to deal with any relevant differences among the classes and subclasses of mail -- the exercise of pricing judgment. See Op. R90-1, at ¶¶ 4051-52 (p. IV-16 to -17). Although Ms. Chown describes her new proposal as a "better metric" (NAA-T-1 at 13), this is merely a difference in packaging. A comparison of her Tables 7-9, which illustrate the application of her proposed metric, with her Table 5, which illustrates the application of the "unbundled" approach proposed in R90-1, reveals that the two approaches are intended to lead to the same outcomes. Id. at 12, 15-17. Both proposals purport to require that different implicit coverages and markups be applied to the so-called "basic functions" performed by the Postal Service so as to reflect the differing mixes of functions used by the various classes of mail and the differing proportions of institutional costs supposedly "incurred" by those functions.

In R90-1, the Commission squarely rejected Ms. Chown's "unbundling" approach, see Op. R90-1 at ¶¶ 4033-52 (pp. IV-11 to -17), as among other things

inappropriately seeking to substitute a mechanical process for the application of the Commission's pricing judgment, and Ms. Chown's new approach should similarly be rejected. Ms. Chown appears to contemplate that the Commission will determine markups for each class (and subclass) of mail, and then apply those markups to "weighted attributable costs," which are not "costs" at all but an imaginary construct that is different from, and unrelated to, any class' actual attributable costs. This exercise, however, would necessarily substitute the purely mathematical formula underlying Ms. Chown's "metric" for the Commission's application of pricing judgment as the way of taking into account any relevant differences among the classes that may lead the classes to use different mixes of functions and (in Ms. Chown's mathematical approach) give rise to the different weights assigned by that metric to attributable costs.

Equally important, like her earlier proposal, Ms. Chown's proposed "metric" is fundamentally flawed in numerous other respects. First, Ms. Chown's proposal is premised on the faulty assumption that there is some causal nexus between the use of a particular Postal Service function by a class of mail and the institutional costs associated with that function. Ms. Chown's testimony variously describes institutional costs as "incurred by," "associated with," and "account[ed] for" by the cost functions that particular classes of mail use, and it is this set of assumptions that appear to underlie her assertion that institutional costs should be allocated on a function-by-function basis. As the Commission has repeatedly

concluded, however, there is no causal relationship between the attributable costs actually incurred by certain classes of mail and the need for the Postal Service to incur institutional costs, whether calculated on a systemwide or function-specific basis. To the contrary, institutional costs are by definition costs that cannot be assigned to a particular class (or classes) of mail, and Ms. Chown's efforts to assign them to particular classes using the proportion of institutional costs in each function to weight (i.e., inflate or deflate) attributable costs is contrary to basic pricing principles. See, e.g., R90-1 at ¶ 4010 (p. IV-4).

Ms. Chown's approach also ignores the fact that the Postal Service does not sell stand-alone "functions" that are produced in isolation from one another. To the contrary, the Postal Service is an integrated provider of mail services, almost all of which make use of multiple Postal Service "functions." Those functions are interrelated, as in the case where automation of mail processing activities permits significant savings in delivery costs through Delivery Point Sequencing, an aspect of Postal operations that is fundamental to the USPS proposals in this case. See, e.g., DMA/USPS-T4-3 (Tr. 11/5677-78). The breadth of the Postal Service's activities allows it to achieve substantial economies of scope and thereby "provide the general public with all classes of mail service at less cost than several individual firms each providing a single class of mail service." See Op. R94-1, App. F at 3. The Postal Service's total institutional costs are thus not merely the result of an accumulation of four (or any other number) of independently-incurred sets of institutional costs

associated with different functions, but instead result from the interaction of all of the Postal Service's services and the different mixes of functions used to provide them. As a result, it is fundamentally illogical and irrational to attempt to allocate institutional cost burdens among the classes of mail in mechanical fashion based narrowly on the mix of functions in which each class incurs attributable costs.

Moreover, even were it theoretically appropriate to assign institutional costs on a "function-by-function" basis as proposed by Ms. Chown, her proposed "metric" performs that function in an inherently arbitrary fashion. There is absolutely no foundation for Ms. Chown's implicit assumption that the "four basic functions" are the appropriate cost groups to which institutional costs should be assigned.^{10/} Different classes and subclasses of mail have very different mixes of costs within the functions proposed by Ms. Chown, and as noted above there are important interrelationships among even the broad groupings Ms. Chown would employ. The Commission noted this fatal flaw in Ms. Chown's proposal in R90-1, see Op. R90-1 at ¶ 4050 (p. IV-16), and her new proposal does nothing to overcome it.

In addition, the implicit premise underlying Ms. Chown's proposed metric -- that different implicit markups and coverages must be assigned to different functions (rather than to different classes, as prescribed by the Act) -- is equally unworkable as a practicable matter. Unless such allocations are to be made in a

^{10/} The notion that "window service," which accounts for only 4.08% of total attributable costs (see Exh. NAA-1C), is one of four "basic" functions, underscores the arbitrariness of Ms. Chown's approach.

purely mechanical manner -- as proposed by Ms. Chown and already rejected by the Commission in R90-1, see Op. R90-1 at ¶¶ 4047-52 (pp. IV-15 to -17) -- there would have to be some way to apply the statutory pricing factors to the discrete functions purchased by each class of mail. Not only would such an exercise be at odds with the Act and the real-world interrelationships among the functions and services provided by the Postal Service, it would also be impossible to undertake because of a complete absence of evidence bearing on the proper application of the pricing factors to determine appropriate function-by-function rate relationships.

CONCLUSION

The DMA believes that, when the record in this case is complete, it will be clear that the Commission should (1) use its prior method for attributing mail processing costs, and (2) allocate to Standard (A) mail a portion of institutional costs substantially smaller than proposed by the Postal Service.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document in accordance with Rule 12 of the Commission's Rules of Practice, as modified by the Special Rules of Practice.


Michael D. Bergman

February 10, 1998